SUPREME COURT, U.S.
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No. 00-1567

In the Supreme Court of the United States

Cornelius P. Young and Suzanne P. Young,
Petitioners,

v.

United States of America,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

PETITIONERS' REPLY BRIEF

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ARGUMENT

The government's argument for automatic tolling of the three-year "lookback" period of Bankruptcy Code §507(a)(8)(A)(i) is flawed for three basic reasons. First, the government considers it axiomatic that the three-year lookback period is a period during which the government is "guaranteed" the ability to collect taxes. Secondly, it considers the automatic bankruptcy stay to be an impenetrable bar that forbids it from collecting a "penny" on its debts. Finally, it assumes that the Youngs and the many other debtor-taxpayers that have litigated this issue are all involved in nefarious tax evasion schemes in which they plot to shift their share of taxes to honest taxpayers. For the reasons that follow, none of these propositions is supportable.

I. THE THREE-YEAR LOOKBACK PERIOD IS NOT A GUARANTEED COLLECTION PERIOD

The government argues repeatedly throughout its brief that the three-year lookback period of Bankruptcy Code §507(a)(8)(A)(i) is a period for collecting taxes, not a part of the definition of which taxes are dischargeable in bankruptcy. For example, the government asserts at page 12 of its brief that failure to allow equitable tolling of the three-year lookback period will result in the government being "...denied the time Congress provided for enforcement in the bankruptcy context." A bit later, the government refers to "...the great weight Congress placed on ensuring the government a three-year period in which to collect tax claims." *Id.* at 13. At page 26, the government speaks of "...Congress's intent to give the government a full three years to collect taxes;..." and later on the same page asserts that

"The balance that Congress struck guaranteed federal, state, and local taxing authorities three years to collect income taxes..." Further along at page 40, it advocates that equitable tolling should apply uniformly to allow "...the government its full three years to pursue the tax claim." and sums up at page 42 with the argument that because of the Youngs' "...serial bankruptcy filings, the government has not yet had the three years Congress afforded it for such efforts."

The proposition that the three-year lookback period is a guaranteed collection period is false for several reasons. First, the legislative history of the enactment in 1966 of the three-year lookback period indicates that Congress was trying to balance three competing policies: the need to give debtors a fresh start unburdened by large accumulations of stale tax claims, the interests of general creditors who do not want to see a debtor's funds exhausted by the payment of stale tax claims, and the public's interest in preventing tax evasion and loss of tax revenue. Both parties agree that these are the concerns Congress had before it in 1966. Pet. Br. 15-16; Gov't. Br. 15-17. Congress responded by enacting the three-year lookback period, which defined which taxes were stale, and thus dischargeable, and which were not. Nowhere in the legislative history, however, is there reference to the three-year period as a guaranteed collection period.

Although the three-year lookback period was intended to define which taxes could be discharged as stale, it of course had the effect of allowing the IRS to collect taxes from a delinquent taxpayer while the taxpayer awaited expiration of the three-year period. It is hardly surprising, then, that the legislative history of the enactment of the Bankruptcy Code refers to allowing the tax collector a "reasonable" or "adequate" time to collect taxes before they are eligible for

discharge in bankruptcy. See Gov't. Br. 17-19. Nothing in this legislative history, however, indicates an intention to specifically guarantee a full three-year collection period to the IRS before taxes could be discharged.

This is because the three-year lookback provision is not the only measuring period that defines which taxes can be discharged. Bankruptcy Code §507(a)(8)(A)(ii) provides that income taxes can be discharged if they were assessed more than 240 days prior to filing the bankruptcy petition. In the Youngs' case, their 1992 income taxes were assessed on January 3, 1994 (App. 6). Since the Youngs had not filed an offer in compromise (App. to Pet. for Cert. 15a; App. 5-8), the 240-day period was not enlarged, and thus expired on August 31, 1994. Since this date fell well before the filing of the Youngs' bankruptcy petitions — their chapter 13 was filed on May 1, 1996, and their chapter 7 on March 12, 1997 — the Youngs met this requirement for discharge of their tax obligation, and the 240-day period is not an issue in this appeal.[1]

Another measuring period is found at Bankruptcy Code §523(a)(1)(B)(ii). That subparagraph provides that taxes are not discharged where the debtor has filed a tax return late and files a bankruptcy petition within two years of filing his tax return. Stated another way, the taxpayer must wait for two years to elapse from the date of filing a late return before filing a bankruptcy petition that will discharge

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[1] The debtors' tax obligation must meet all the Bankruptcy Code's measuring periods to be discharged.

the tax obligation reflected on that return.[2]

The two-year measuring period did not apply to the Youngs since they filed their 1992 tax return on time on October 15, 1993, after obtaining two filing extensions. App. 6.[3] In other circumstances, however, either the two-year or 240-day period could come into play as the controlling measurement, thereby effecting a period shorter than three years for tax collection. For instance, assume a taxpayer who has filed a return on time and paid the tax shown on the return

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[2] A taxpayer must also satisfy the 240-day and three-year measuring periods to be able to discharge taxes reflected on a late-filed return. Furthermore, tax obligations reflected on a late-filed return do not attain priority status in chapter 13, and are treated as general unsecured claims, assuming that the three-year and 240-day measuring periods elapsed before the filing of the chapter 13 petition.

[3] Had the Youngs filed their 1992 tax return on October 15, 1993 *without* obtaining the two filing extensions, their tax obligation would have been a non-priority claim in their chapter 13 proceeding (and dischargeable had their plan been completed) or simply discharged in their chapter 7 proceeding. This is because the due date for filing the return (*without* extensions) would have been April 15, 1993. Three years from April 15, 1993, expired on April 15, 1996; the Youngs' first bankruptcy filing was 16 days later on May 1, 1996, so the three-year rule would have been satisfied. The two-year rule for a late-filed return (filing on October 15, 1993, without obtaining the extensions makes it late) would have been also satisfied, since that period expired on October 15, 1995. Of course the 240-day period ran out on August 31, 1994.

In effect, the Youngs are penalized for complying with the law by obtaining the extensions. The fact that they obtained the extensions also suggests that the Youngs were not involved in a manipulative scheme of tax avoidance.

in full. About two years[4] later, the IRS decides to conduct an audit because it questions some deductions claimed by the taxpayer on his or her return. The taxpayer meets with a revenue agent, the agent requests that records substantiating the deductions be produced by a certain date, discussions are held, more records are requested and produced, and time passes. The taxpayer does not agree with the adjustments sought by the IRS, and consequently the District Director sends the taxpayer a so-called 30-day letter. The taxpayer fails to respond to this notice, so the IRS sends a statutory notice of deficiency, also known as the 90-day letter. The taxpayer then has 90 days to petition the United States Tax Court to contest the IRS's determination. The taxpayer fails to file a petition with the tax court, so the IRS thereupon proceeds to assess the additional tax. By this time, there are only two months left before expiration of the three-year period allowed under IRC §6501(a) to assess the tax. Two hundred forty-one days after the assessment, the taxpayer files for bankruptcy. The taxes assessed eight months earlier

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[4] It is not unusual for the IRS to initiate an audit (or "examination" in IRS parlance) two years from the filing of a return. The IRS follows a so-called audit cycle, which provides that examination of individual tax returns must be completed within twenty-six months of filing. M. Saltzman, *IRS Practice and Procedure* (1991), ¶ 8.06, p. 8-30. Indeed, Congress appears to have had the audit cycle in mind when it enacted the three-year lookback period as part of the Bankruptcy Code: "Because of the difficulty of auditing and collecting income taxes, the priority is left at three years. However, with respect to other taxes, such as customs, excise and property taxes, it is easier for the taxing authority to discover a delinquency and easier to audit, because the computations necessary to determination of those taxes are not as intricate as those necessary for income taxes." H.R. Rep. No. 595, 95th Cong., 1st Sess. 190-91 (1977).

will be discharged, as both the three-year and 240-day measuring periods have been satisfied, even though the IRS has had only 240 days to collect the recently-assessed taxes.

Similarly, in the hypothetical involving the Youngs described earlier at footnote 3, the IRS did not have a full three years to collect the tax, since the return was filed six months late on October 15, 1993. Generally, until a return is actually filed, the tax cannot be assessed,[5] and until it is assessed, it cannot be collected.[6] Using the dates in the Youngs' hypothetical, then, the taxes would be discharged, even though the IRS had only two years and 117 days between the assessment date (January 3, 1994) and the chapter 13 filing date (May 1, 1996) to collect. If measured from the date the return was filed, October 15, 1993, there elapsed two years and 198 days, still less than three years.

Congress, then, did not enact the three-year lookback period in Bankruptcy Code §507(a)(8)(A)(i) as a guaranteed time allowance for collecting overdue taxes before they became eligible for discharge under the Bankruptcy Code. While the three-year lookback period may have the effect of

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[5] The IRS can assess a tax without having received the taxpayer's return by preparing a "substitute for return" from whatever information it has (prior year's return, W-3 forms from employers, 1099 forms from banks and so forth) and then assessing a tax based on this return. IRC 6020(b).

[6] This is an over-generalization, but only slightly so. The IRS may, "without assessment," sue in court to collect taxes, provided that it brings suit within three years of the filing of the return. IRC 6501(a). This happens so infrequently, however, that as a practical matter the proposition is true.

affording the IRS a full three years of collection activity in some circumstances, Congress' enactment of the 240-day and two-year measurement periods sharply reduces the time available for collection in other circumstances where those provisions come into play. Since these measurement periods do not guarantee a full three years of enforced collection activity in all circumstances, we must regard them not as tax collection windows, but as separate parts of the definition of dischargeable taxes.

Indeed, Congress, when discussing the tolling of limitation periods under Bankruptcy Code 108(c), regarded the explicit tolling provisions there (along with the complementary provisions of IRC §6503(b) and (h)) as ". . . protect[ing] the right of governmental units (and other creditors) to collect debts which are *not discharged* in the bankruptcy proceeding." S.Rep.No. 989, 95th Cong., 2nd Sess., 14-15, (emphasis added), quoted at Gov't. Br. 18. From the same report, as quoted in both the government's brief (pp. 19, 37) and the petitioners' brief (p. 20), taxing authorities shall have "adequate time to collect *nondischargeable* taxes following the end of the title 11 proceedings" (emphasis added). The Youngs do not (and indeed cannot) have any quarrel with allowing the IRS — since Congress has explicitly so provided — an extension, measured by the duration of their bankruptcy proceedings, of the ten-year period allowed under IRC §6502(a)(1) for the collection of any nondischargeable taxes they owe. They object only to being denied a discharge of their 1992 taxes, which the Bankruptcy Code (including the tolling provisions of §108(c)) explicitly defines as dischargeable.

II. CONTRARY TO THE PREMISE OF THE GOVERNMENT, THE AUTOMATIC STAY DOES NOT PROHIBIT IT FROM COLLECTING MONEY FROM DEBTORS WHILE THEY ARE IN BANKRUPTCY

Another axiom of the government's argument is that the automatic stay precludes the IRS from collecting even "a penny"[7] from debtors while they are in bankruptcy. It assumes such preclusion under the question it presents to this Court at the outset of its brief (p. (I)), and repeats the proposition several more times.

For example, at page 8, it asserts that the petitioners' chapter 13 filing "...barred the government from taking any further measures to collect the remaining unpaid taxes." Later, it advocates tolling of the three-year lookback period for "...the period in which the automatic stay in the chapter 13 bankruptcy case precluded the government from enforcing its claim." Gov't. Br. 10. Further along, it argues that equitable tolling of the three-year lookback period is appropriate for the length of time the government "...is legally barred from enforcing its claim..." in a prior bankruptcy. *Id.* at 12. Finally, it urges this Court to adopt a uniform rule that equitable tolling be applied for the length of time that the automatic stay "...denied the government its full three years to pursue the tax claim." *Id.* at 40.

The petitioners have pointed out in their main brief (pp. 21-25) that the automatic stay does not prevent the IRS

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[7] Gov't. Br. at 27, n. 8.

from collecting taxes from debtors for the entire duration of their reorganization proceeding, whether completed or aborted, even if the automatic stay remains in force with respect to the IRS for that length of time. We pointed specifically to the *Brickley* case (*Brickley v. United States (In re Brickley)*, 70 B.R. 113 (9th Cir. B.A.P. 1986)), indicating that, assuming the Brickleys' chapter 13 plan had indeed been confirmed, the IRS was receiving payments on its tax claim while the chapter 13 proceeding was ongoing, and even with the automatic stay still in force.

Admittedly, the Youngs' case is different. As the government correctly points out (Gov't. Br. 8) the Youngs' plan was not confirmed,[8] and with the filing of their notice of dismissal, the plan payments they had already paid to the chapter 13 trustee were refunded to them and were not paid to the IRS or any other creditor. Between the filings of their chapter 13 petition and their notice of dismissal there elapsed 176 days, after which the automatic stay dissolved by reason of Bankruptcy Code §362(c)(2)(B).

For these 176 days, the IRS was barred by the automatic stay from enforced collection, such as filing a notice of a tax lien with respect to the Youngs' property, or levying their bank accounts or salaries. Nevertheless, the IRS did file two proofs of claim in the Youngs' chapter 13 case (the second amended the first, App. 18-27), and had the Youngs' plan been confirmed on November 15, 1996, the IRS

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[8] The Youngs' chapter 13 case was filed on May 1, 1996; the hearing on confirmation of the debtors' chapter 13 plan was scheduled for November 15, 1996. App. 11. The Youngs filed their notice of dismissal on October 23, 1996, about three weeks prior to the scheduled confirmation hearing.

would have received both its share of the plan payments accumulated by the chapter 13 trustee while awaiting confirmation as well as regular plan payments thereafter.

Looking at the specifics of the Brickleys' and Youngs' situations suggests that the uniform tolling rule that the government urges this court to adopt (Gov't. Br. 40) be examined more closely. Of course, the Youngs do not concede that a tolling rule of any type is permissible, since a plain reading of the applicable statutes does not allow for one.

The rule urged by the government provides that "Equitable tolling should apply uniformly in all cases where the automatic stay entered in a debtor's earlier bankruptcy proceeding denied the government its full three years to pursue the tax claim." *Id.*

In the Brickleys' case (assuming their chapter 13 plan had indeed been confirmed), the IRS was collecting payments on the Brickleys' tax obligations even while they were in chapter 13, and even while the automatic stay was in force. The Brickleys remained in bankruptcy for about two years and nine months before they elected to dismiss their case; their plan (assuming it was confirmed) had to provide for ". . .the full payment, in deferred cash payments, of all claims entitled to priority under section 507...." Code §1322(a)(2). Furthermore, the Brickleys had to start making plan payments to the chapter 13 trustee within 45 days[9] of filing their chapter 13 petition. Once their plan was confirmed, the chapter 13

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[9] Debtors have 15 days from filing their bankruptcy petition to file their chapter 13 plan, unless extended by the court (Bankruptcy Rule 3015(b)), and 30 days after filing the plan to commence making plan payments (Bankruptcy Code §1326(a)(1)).

trustee would have distributed the plan payments accumulated pre-confirmation to creditors, including of course the IRS. Thus, in the Brickleys' case, the IRS collected at least 31 months' worth of payments, even while the automatic stay was in full force preventing "pursuit" of the debtors. Furthermore, the payments had to be of a magnitude that would have paid off the Brickleys' IRS obligations "in full" by the end of their plan.

Yet the tolling rule advocated by the IRS, if we understand it correctly, would simply toll the three-year lookback period by the amount of time the automatic stay was in effect during the prior bankruptcy proceeding regardless of what was paid to the IRS during that proceeding. The proposed rule thus overreaches. The premise of the proposed tolling rule is to allow the government a full three years from the due date of the return to "pursue" collection of delinquent taxes from debtors; if the IRS had collected payments from the Brickleys for 31 or 32 of the 33 months the Brickleys were in chapter 13, there is no logical reason to allow tolling beyond the one or two months at the outset of the case when the Brickleys were filing their plan and getting up to speed with their payments.[10]

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[10] In the Youngs' case, their chapter 13 plan was not confirmed, and the plan payments they had been making to the chapter 13 trustee pre-confirmation were refunded to them upon dismissal. The Youngs' chapter 13 case lasted 176 days until dismissal, during which the automatic stay prevented "pursuit" by the IRS. Applying a logical tolling rule in the Youngs' case would allow tolling for 176 days, which would reduce the Youngs' lookback period to two years, 336 days. Of course, the Youngs consider that tolling of whatever length, and however computed, is not permitted under the Bankruptcy Code except as explicitly set

If tolling for tax claims is allowed, logic also requires that tolling be allowed for priority unpaid wage claims, as defined by Code §507(a)(3), and priority unpaid employee benefit claims as defined by Code §507(a)(4). The first of these subsections, (a)(3), allows as a priority claims for unpaid wages, salaries and commissions of up to $4,650 earned by the debtor's employees within 90 days of the petition date or the date on which the debtor's business ceased, whichever is earlier. The following subsection, (a)(4), provides priority treatment of claims for unpaid contributions to an employee benefit plan arising from services rendered within 180 days prior to the filing of the debtor's bankruptcy petition. Both types of claims enjoy payment priority ahead of recently-incurred tax claims, as defined at § 507(a)(8), in a chapter 7 liquidation. Both types of claims would have to be paid in full, together with priority tax claims, in a chapter 13 case. Code §1322(a)(2).

Within Code §507, the only types of claims that incorporate time elements as part of their definitions are wage and salary claims, §507(a)(3), employee benefit plan claims, (a)(4), and tax claims, (a)(8). The logic of tolling requires that the 90-day and 180-day lookback periods of §507(a)(3) and (a)(4) be tolled as well if tolling is applied to tax claims. Yet research has not revealed any case to the petitioners in which tolling of the 90 and 180 day lookback periods has ever been granted by reason of a prior bankruptcy filing. Allowing tolling only for tax claims, and not the wage and benefit claims, could, in certain circumstances[11] allow the tax claim

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forth therein.

[11] To illustrate, take the Youngs' actual situation, which is described above at footnote 3. Add the fact that Mrs. Young

to leapfrog ahead of the wage and benefit claimants on the priority ladder set by Congress at Code §507. Among other things, this would violate this Court's holding in *United States v. Noland*, 517 U.S. 535 (1996), which prohibited a bankruptcy court from a categorical reordering of the priorities set forth at Code §507 through the application of equitable considerations.

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operated a business as a proprietor under the name of "Young Impressions Art Studio." App. 10, 34. Imagine, hypothetically, that at the time her chapter 13 petition was filed on May 1, 1996, that she had accrued a debt 20 days earlier for an unpaid contribution to an employee benefit plan for her employees. By reason of Code §1322 (a) (2), the Youngs' chapter 13 plan had to provide for payment in full over the course of the plan of both the claim for the contribution to the employee benefit plan as well as the IRS claim.

The Youngs dismiss their chapter 13 case on October 23, 1996, and file for chapter 7 on May 12, 1997, 147 days after dismissal. Assume, hypothetically, that there are assets in the chapter 7 case, but they are insufficient to pay both the contribution to the employee benefit plan and the IRS in full.

The chapter 7 trustee proceeds under Code §726(a)(1) to distribute assets of the bankruptcy estate in accordance with the priorities set out at §507. With no tolling allowed whatsoever, both the contribution claim and tax claim are paid prorata as general claims; claims having priority, such as a claim for alimony or child support, are paid first. Code §507(a)(7). Allowing tolling for both the contribution claim and IRS claim places the contribution claim ahead of the support claim and the IRS claim behind it. Allowing tolling for the IRS alone places the IRS claim behind the support claim but ahead of the contribution claim.

III. THE PETITIONERS ARE NOT INVOLVED IN A TAX-AVOIDANCE SCHEME.

The government also argues that debtors have, on a widespread basis, tried to use the mechanism of serial bankruptcy filings as a tax-avoidance scheme. Gov't. Br. at 12-13. It appears to cast the Youngs among these ("Petitioners' manipulation of the Code...," *id.* at 26), even though the bankruptcy court below found that "...it imputes no bad faith on the Plaintiffs...." App. to Pet. for Cert. 20a.

This finding of the bankruptcy court is supported by the record. Between the due date for filing their 1992 tax return, October 15, 1993, and the filing of their chapter 7 bankruptcy proceeding on March 12, 1997, there elapsed three years and 147 days. Subtracting out the 176 days that they were in chapter 13 (should tolling apply) left the Youngs 29 days short of a full three years exposure to the IRS's collection efforts. During this period, the Youngs made monthly payments to the IRS for 20 months between April 1994 and November 1995. App. 6-8. The Youngs did not file their chapter 13 bankruptcy until May 1, 1996, two years and six and one-half months after the due date for filing their 1992 tax return. While in Chapter 13, they sold their house, paid off mortgage and tax liens on it in the process, and later became involved with hiring Attorney Norene Farr for a purpose that does not appear in the record.

This is not a picture of people engaged in a manipulative scheme to avoid paying taxes. Indeed, the government, in responding to the Youngs' complaint to have their 1992 tax obligation discharged, did not attempt to submit any evidence of the Youngs' motives; instead it proceeded

directly to filing a motion for summary judgment without even filing an answer to the Youngs' complaint. App. 1.

Even among the scores of other taxpayer-debtors who have litigated this issue, few have actually been found to be involved in a bad-faith manipulative scheme of tax avoidance. Three cases cited by the government (Gov't. Br. 22, n. 6), *In re Hollowell,* 222 B.R. 790 (Bankr. N.D.Miss. 1998); *In re Miller,* 199 B.R. 631 (Bankr. S.D.Tex. 1996) and *In re Clark,* 184 B.R. 728 (Bankr.N.D. Tex. 1995) appear to be the exceptions that prove the rule. Elsewhere, while courts (including the bankruptcy court and court of appeals below) talk of the possibility of taxpayer manipulation, they seldom find that the taxpayers that are appearing before them have actually been carrying on some manipulative tax-avoidance scheme. Indeed, the large volume of litigation on this issue can be better explained by the existence of a large number of debtors who believe that the Bankruptcy Code means what it says and are then surprised to find that the government thinks otherwise.

IV. THIS COURT SHOULD LOOK TO THE LANGUAGE OF THE STATUTES THEMSELVES TO DETERMINE CONGRESSIONAL INTENT.

In this appeal, the government has argued that legislative history and the statutory schemes of the Internal Revenue and Bankruptcy Codes, when taken as a whole, prove its two hypotheses: (a) that taxing authorities are entitled to a full three years in which to collect overdue taxes; and (b) that bankruptcy proceedings automatically prevent any collection whatsoever of these taxes while such proceedings

are pending. The government's approach puts the cart before the horse. Rather than focusing on the language of Congressional debates, committee hearings and reports to determine Congressional intent, it should have first looked at the ultimate distillation of Congressional intent: the language of the statutes themselves. Only if a reading of these statutes created an ambiguity or created absurd results demonstrably at odds with the intent of Congress is it necessary to delve into legislative history and the entirety of the legislative scheme.

The government has not met its burden in this case. The statutes are intricate, complex and convoluted, but they are not ambiguous. Nor does a plain reading of them create absurd results that do not comport with the intent of Congress. To the contrary, they carry out the intent of Congress to balance the tension between giving debtors a fresh start unencumbered by the burden of large accumulations of stale tax claims, the interests of creditors who do not want to see a debtor's funds exhausted by the payment of stale tax claims, and the public's interest in preventing tax evasion and loss of tax revenue. These purposes are reflected both in legislative history and in the statutory schemes taken as a whole.

The government's insistence that its two hypotheses also be incorporated into the already-complex statutory schemes of the Bankruptcy Code and Internal Revenue Code would unbalance the mechanism that Congress has already enacted. The solution to what the government perceives as manipulative schemes to avoid paying taxes should not be formulated by forcing an oversized roughly-hewn square peg into a finely-machined round hole. The IRS should instead participate in, and not merely spectate at, bankruptcy

proceedings, including in particular the few bankruptcy cases where there is genuine manipulation and abuse. It should also allow the honest taxpayer-debtors the relief Congress intended them to have.

CONCLUSION

For the reasons set forth above and in the petitioners' main brief, this Court should reverse the holding of the United States Court of Appeals for the First Circuit and hold that the Youngs' 1992 income tax obligation was discharged by their chapter 7 bankruptcy.

Respectfully submitted,

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